



1st March 2010

Alice through the breaking glass

“More than any other time in history, mankind faces a crossroads. One path leads to despair and utter hopelessness. The other, to total extinction. Let us pray we have the wisdom to choose correctly.”

- Woody Allen.

In Frédéric Bastiat's parable, a shopkeeper has a window broken by his son and is obliged to pay, say, six francs to fix it. Some onlookers reason that breaking windows is a good thing, since it causes money to circulate – in this case, into the hands of a grateful glazier. But Bastiat points out that since the shopkeeper has had to spend six francs on getting his window repaired, he has been deprived from spending the money on anything else. The benefits of purchasing a new window are illusory, since they ignore the cost to the shopkeeper.

Consider, alternatively, the fates of Japan and Germany at the end of the Second World War. The economies of both defeated powers were shattered. Japan and Germany as nations may have lost the war, but their economies won the peace. Japan rapidly modernized into a robust industrial economy. Ditto Germany, which enjoyed what 'The Times' in 1950 called a *Wirtschaftswunder*, an economic miracle, as it emerged from the ashes. This has led some strategists to suggest, not entirely facetiously, that it would be in the best interests of an ailing industrial economy – Britain's, say – to have its factories and economic infrastructure routinely and totally destroyed, every so often.

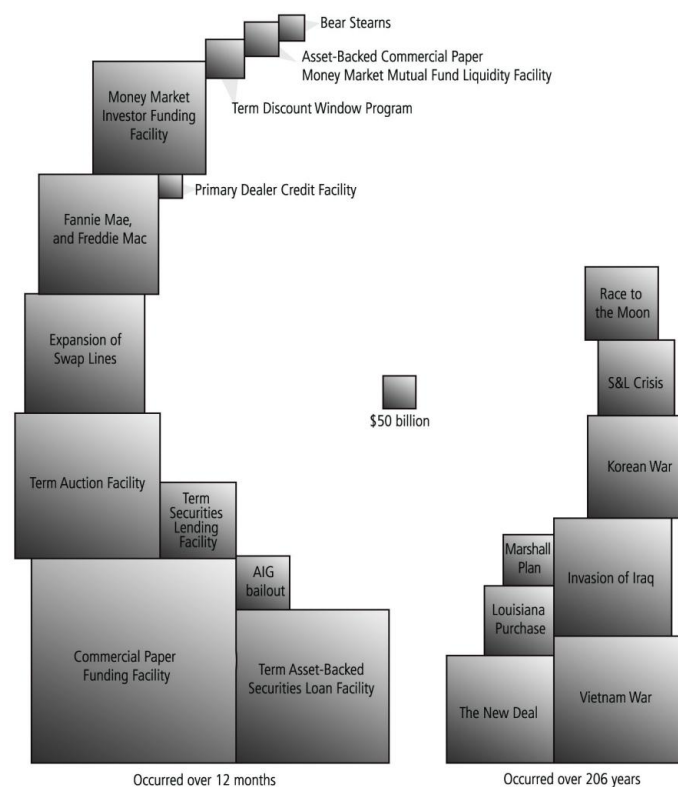
There is another, more recent, application of a theory involving broken windows. An article entitled "Broken Windows" was published in 'The Atlantic Monthly' in 1982. Consider, it posited, a building with a few broken windows. If those windows are left unrepaired for any length of time, there will be a tendency for vandals to break some more. The downtrend may lead to the building's being occupied, or torched. The article became a book, and its author, George Kelling, became a consultant to the New York City Transit Authority in 1985, which duly implemented the theory. Kelling went on to work with the LAPD and the Boston Police Department. New York City Mayor Rudy Guiliani and his police commissioner Howard Safir are also credited with using a similar "broken windows" / zero tolerance approach to urban crime, which caused both petty and serious crime rates to fall materially over a decade.

The financial sector is now littered with shards of broken glass, in both metaphorical senses. A creeping lapse in ethics has permeated the system; bad money, if you will, has crowded out the good. And in its zeal to quench the resultant banking conflagration with torrents of capital that

amount to claims on future generations, Big Government is now threatening to drown the survivors. It is a necessary but not sufficient condition for recovery that financial practitioners start to learn how to navigate with a moral compass. Since the moral rot has become endemic, the rolling crisis may require a fundamental change in our politics before it finds resolution.

Huge crises can swell from seemingly inconsequential sources. In chaos theory, small differences in initial conditions, within a complex and dynamic environment highly sensitive to those initial conditions, can trigger widely divergent outcomes. A fraudulent mortgage broker extending credit to an impecunious borrower leads to the real possibility of a sequence of sovereign bankruptcies. Where that sequence ends (Iceland ? Ireland ? Greece ? The UK ? The US ?) is anybody's guess. But the malign original input need not be strictly illegal. It might merely reflect skewed incentives. Portsmouth FC on Friday became the first Premier League football club in the UK to enter administration. Which shows that the business of football, at least, operates like a proper market, in which outright failure is always a possibility. What football has in common with banking is the sense of entitlement on the part of its employees. Portsmouth's wage bill accounted for 90% of the club's turnover. Having made an operating loss of £6.2 billion in 2009, RBS feels obligated to pay at least 100 of its investment bankers at least £1 million in bonuses for 2009. The bank presumably believes that it might run into difficulties as a business if it does not. UK taxpayers are the owners of RBS, but they have not been consulted over its remuneration policy (or lack thereof). As bankers determinedly polish up their tin ear to public criticism, those who work in genuinely entrepreneurial, risk-taking professions, facing a rising tide of taxation and diminished public services, are justified in thinking despairingly of taking their wealth-creating, economic value-adding abilities to a locale that might more properly appreciate them. Can you have an economy that consists solely of state-employed bankers selling each other financial services ? We may soon see.

The cost of Big Government gets bigger



Source: www.ritholtz.com

The costs of the financial bailout to date contain too many zeroes for the average human brain to comprehend, but the visual above makes the extent of the commitments to date a little more comprehensible. The blocks on the right of the page show some of the US administration's previous undertakings – the cost of the Space Race, for example, or paying for a big previous financial bust, that of the Savings and Loan crisis of the 1980s. A little block marked \$50 billion is there to show relative scale. Those costs were incurred over a period of a little more than two centuries. The costs of the bailout this time round are shown on the left. They occurred over a period of 12 months.

Fleets of enemy bombers did not destroy the banking system. The bankers managed it all by themselves. This increasingly desperate game of 'pass the parcel bomb to a future generation' has now seen the debt and currency markets of the most heavily indebted (reality denying) governments start to replay the role formerly undertaken by bank stocks in a race to the bottom. For as long as this increasingly manic game persists, the only rational proactive response is to seek refuge in gold. And by way of reactive response, simply to step out of the way of government-sanctioned assets – bonds and currencies – as they wend their way down toward their intrinsic value.

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